IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

Nos. 278, 279, 280, 281 and 282.

RECONSTRUCTION FINANCE CORPORATION, INSURANCE GROUP COMMITTEE, *et al.*,

Petitioners,

—against—

THE DENVER AND RIO GRANDE WESTERN RAILROAD COMPANY, *et al.*,

Respondents.

(and the other four cases numbered above).

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT.

APPENDIX TO BRIEF ON BEHALF OF RESPONDENT, CITY BANK FARMERS TRUST COMPANY, AS TRUSTEE UNDER THE DEBTOR'S GENERAL MORTGAGE.

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APPENDIX TO BRIEF ON BEHALF OF RESPONDENT, CITY BANK FARMERS TRUST COMPANY, AS TRUSTEE UNDER THE DEBTOR'S GENERAL MORTGAGE

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1. Abstract of Part of the Testimony of Witness, Miles C. Kennedy, at Confirmation Hearing, August 30, 1944 (R. 310-332)

My name is Miles C. Kennedy. I live at 45 Fifth Avenue, New York. I am a consulting engineer, a member of the firm of Coverdale & Colpitts, consulting engineers; office at 120 Wall Street, New York City.

"Q. Will you please give a brief statement of your professional experience?

The Court: Is there any question as to his qualifications by anyone?

Mr. Homire: We will waive any question as to that.

Mr. Gibson: We will do likewise.

The Court: All right.

Mr. Watts: Your Honor, may I inquire whether that goes to the extent of—I hope to bring out in these qualification questions the fact that the witness and his firm have in a very large number of railroad reorganizations served as special advisers and consultants to the bondholders, bondholder committees, creditor groups and the like.

The Court: That fact is well known to the Court and I presume it is to all the parties here.

Mr. Gibson: We so admit."

I have examined the two exhibits which have just been introduced, being City Bank Farmers Trust Company Exhibit 10 and Exhibit 11 [See R. 349, 350]. * * *

To the best of my knowledge, the substance of the information which is outlined in both of these tables, and particularly the table included in Exhibit No. 11 [See R. 350], has been available to the public and to the holders of the General Mortgage bonds. * * * The income accounts are, of course, published in the daily press, and all the information in regard to the plan has been in financial papers, dailies, weekly, statistical services and the manuals which are readily available.

In my opinion this is the kind of information which would and which should be carefully considered by the General Mortgage Bondholders in determining how they should vote on the acceptance or rejection of the plan of reorganization. I think it is very important information. * * *

I think one of the highly significant facts * * * is * * * that as of December 31, 1943, the last previous year end to the submission of the plan, all the interest on obligations senior to the General Mortgage Bonds had been earned with a margin of $3,859,306.00 to spare. In other words, if the amounts earned available for interest on the senior obligations had been paid to the holders of those obligations, the position of the General Mortgage would have been no worse than it was at the beginning of the receivership.

Now, as compared to that, the other significant fact is * * * that in the first plan filed, which was the debtor's plan, the General Mortgage was accorded 100 per cent treatment in new preferred stock. * * * That is, they would have gotten dollar for dollar in par amount in satisfaction of their claim as of that date, or their principal amount as of that date. The next plan was the Insurance Group plan of 1937 which gave the General Mortgage 100 per cent in new common stock. After hearings before an examiner of the Interstate Commerce Commission the examiner recommended fifty per cent in new common stock. The Interstate Commerce Commission in two subsequent plans awarded thirty-three and one-third per cent. One of these was in 1939, and one was in 1940. A certain discussion plan more or less agreed upon—I don't know exactly—in 1941 again gave the General Mortgage bonds fifty per cent. The Court's plan of 1941 brought the amount to 32.99 per cent, to practically thirty-three per cent, and in 1941, * * * the Insurance Group plan accorded the General Mortgage 47.42 per cent.

Then we get along to 1942 and the Interstate Commerce Commission cut the percentage down to five per cent, and in 1943 they doubled that treatment by giving them ten per cent. Now, coupled with that fact is that the earnings

of the property had been improving steadily since about 1937, when, * * * there was a deficit of $249,880.00 in income available for interest. *Those earnings increased very substantially*, due in part I should say to the generally increasing prosperity, *due in rather large part I should say to the improvements which were being made in the debtor's program, under which very large amounts were spent for improvements which it is reasonable to assume produced very substantial savings or increases in revenues.*

The figure $3,859,306.00, which I referred to, * * * represented the accumulated surplus up to December 31, 1943, of the income available for interest over the interest requirements of the so-called senior obligations. *It is true that the period during which that figure was built up included some abnormally good years, but it may also be said that some of these years were abnormally bad years*, and, furthermore, in some of these years in the period, perhaps all of them, the earnings were reduced because of the expenses incident to the very large improvement program which I just mentioned. * * *

I know in a general way what was done with the money which was earned but which was not paid out to the security holders. *Up to the end of 1943 the trustees under the direction of the Court had expended, I think about $37,000,000.00 in improvements, additions and betterments to the property.* All of that money did not come from the accumulated earnings set forth here. Part of it came from equipment trust issues I think in the amount of some five to six million dollars. Part of it was, of course, accrued in depreciation accounting, *but it is quite clear that the earnings of the property throughout this period in general have been used to improve and strengthen the property in the discretion and wisdom of the trustees and the Court.*

I am familiar with the fact that over the period as a whole there has been an increase in the cash and current assets over current liabilities. *There have been very substantial increases.*

I would start out with the assumption, I believe, that the trustees of this property were acting with all wisdom and discretion not only because they were appointed by this Court and confirmed by the Interstate Commerce Commission, but because I know and *I believe it is a matter of general information that the trustees have done an outstanding piece of work for this property.* I would therefore believe that in diverting funds from the payment of interest to investments in the property *the trustees were doing what they believed and what was for the benefit of the debtor's estate and for the security holders for whom they were trustees.* From that I draw the conclusion that they considered the investment of this money in additions and improvements much more beneficial to the security holders of the company than the payment to them of current interest, because *I do not believe that they would do anything to worsen the position of their security holders or any class of them;* certainly not willingly.

* * * * * * *

Now, of course, it is reasonable to believe that the expenditures that these trustees made have been productive and will be productive of very substantial earnings. I spent several years with the Pennsylvania Railroad making economic studies of the savings it had out of new work, the added traffic to be obtained by new lines and extension of lines, and I know very well an improvement that didn't earn fifteen per cent on its cost or was not estimated to earn fifteen per cent on its cost would receive no consideration whatever from the management, and *I therefore assume that these improvements or most of them could be expected to earn ten per cent to fifteen per cent or even more in some cases.*

Now, if that is the case the position of the bondholders is improved, and *even though money has in effect been borrowed from the bondholders through the non-payment of interest,* which has been used for making improvements, there is bound to be considerable income in excess of the

interest that will be paid on that money when interest is again resumed, and that benefit would flow down to the junior issues in the reorganization. *I should therefore conclude that the position of the General Mortgage—what I have already said is true—the position of the General Mortgage should be better rather than worse through the expenditure of this money by the trustees even though it has meant the piling of additional debt ahead of the mortgage.*

* * * * * *

I am not talking about maintenance. I am talking about improvements over and above the maintenance.

* * * * * *

You could have replaced various parts of the property in kind. Instead of that you went out and built better bridges than you had before. You bought better equipment than you had before. Understand I am not criticising in any way any part of this program. Relying upon the trustees, as I said, I have no inclination to criticise anything that was done. I am saying, however, that the money hat was used to make a substantial part of these improvements was in effect borrowed from the bondholders and claims piling up on the reorganization on which interest will be paid. * * *

I spoke before of a substantial improvement in the debtor's cash position as of December 31, 1943. If you will give me that 1943 report that Mr. Thompson introduced——

From page 12 of this Exhibit No. 8 [1943 Annual Report] which Mr. Thompson introduced this morning, the cash as of December 31, 1943, was $12,716,934.00. Temporary cash investments were $8,005,000.00. Total current assets were $33,915,000.00, roughly, and current liabilities were $23,517,000.00, also roughly, which gives net working capital of approximately $10,400,000.00.

In view of the cash distributions which have been and were being provided for security holders in numerous other reorganization proceedings before the Interstate Commerce

Commission and before the courts, it was in my opinion reasonable for the General Mortgage bondholders to assume that some of this cash to which I have just been referring might be used to reduce accrued interest on obligations prior to the General Mortgage bonds, and thus improve the position which the General Mortgage bondholders might expect in the plan of reorganization. I can think of several cases where cash distributions were made to reduce claims, and those cases, generally speaking received rather wide publicity, and it would be quite natural for bondholders not only in this company but in other companies to expect or have strong hopes that similar distributions would be made in these cases.

"Q. I come now, Mr. Kennedy, to the question for which I have been laying the groundwork by these previous questions, and first I want to read again certain language of subsection (e) of Section 77 of the Bankruptcy Act, which says that: 'if the plan has not been so accepted by the creditors and stockholders'—that means by the vote of two-thirds of each class of securities entitled to vote—'the judge may nevertheless confirm the plan if he is satisfied and finds, after hearing,'—then I will skip a little—'that such rejection is not reasonably justified in the light of the respective rights and interests of those rejecting it and all the relevant facts.' Without reading the balance of these requirements, *in your opinion, based upon your general experience in such matters and upon the testimony which you have just given, was the rejection of this plan by the General Mortgage bondholders reasonably justified in the light of the respective rights and interests of those rejecting it and all the relevant facts?*

"Mr. Gibson: Your Honor please, that forces an ultimate question of law. The statute implies whether your Honor is satisfied, not whether Mr. Kennedy is satisfied. We doubt if the witness is competent to express an opinion on that ultimately.

"The Court: I think the objection is good, but I will let him answer if you want it in the record.

"Mr. Watts: We are just asking his opinion.

"The Court: You are asking his opinion how someone else should make up their minds. He can answer, but I don't know what value it will have.

"A. *In my opinion it was.*"

* * * * * * *

On that day, November 1, 1935, there were $102,000,000.00 of obligations ahead of the General Mortgage bondholders. * * *

* * * * * *

The principal of the General Mortgage debt on November 1, 1935, was in the neighborhood of twenty-nine million. So, * * * there was one hundred thirty million of debts to be compared with the one hundred and forty million capitalization. By that I mean principal amount. *So that if this plan of reorganization had been put into effect on November 1, 1935, on the basis of any valuation that has been used in this proceeding, I should judge that the General Mortgage claim would have received at least 100 per cent in new securities or shares under that capitalization.*

Now we are nine years or thereabouts later. The indebtedness they are putting ahead of the General Mortgage bonds now in this plan of reorganization which is now before the Court (referring to documents) I should say is about $140,000,000.00. That is Rio Grande securities alone, not the Denver & Salt Lake. * * * So that through lapse of time they have allowed to be accumulated on creditor's claims ahead of the General Mortgage bonds and other creditors some thirty-odd million dollars.

*And that has reduced the distributive share of the General Mortgage Bonds in the securities of this reorganization unless the capitalization is increased to allow for the improvements they have made, * * * during this receivership period, which have added to the value of the property, and certainly have added very substantially to its earning power.*

But they have not increased the capitalization over and above the original capitalization by more than $7,000,000.00. And the result is that the General Mortgage Bonds are shoved down below thirty million more than would have been the case on November 1, 1935. * * * That has been the effect. * * * *During this time this property has been improved very substantially.*

The figures of the improvement program, what has been invested, there has been approximately thirty-seven million, as I recall, invested from the date of receivership to the date of December 1, 1943.

We have before us for every year a statement of net income which I have seen. For every year of the operation of these trustees, and before reaching that figure of net income, all maintenance expenses are deducted from income. * * * *I think very definitely in this period of improvement of this property there has been an actual improvement in the useful value of this property, in the utility of this property.* To form any other conclusion you would have to conclude that the trustees had not known their business, didn't know what they were doing.

I know that lines have been abandoned during that period. I wouldn't have to look at it, Mr. Hodges, to give an opinion as to whether the abandonment of these lines has improved the general efficiency and utility of the plant. I know *perfectly well that the Interstate Commerce Commission approves the abandonment of a line which means that line has been a decided drain on the system, and therefore the abandonment has meant an improvement to the property.*

2. Abstract of Part of the Testimony of Witness, Ralph E. Morton, at Confirmation Hearing, August 30, 1944 (R. 335-339)

My name and address is R. E. Morton, 22 William Street, New York City. I am one of two vice-presidents in charge of the Corporate Trust and Reorganization Department of the City Bank Farmers Trust Company, having been assigned to that department in May, 1927. I have as part of my personal work in that department the administration of trusts created by railroad mortgages. City Bank Farmers Trust Company has had many railroad mortgage trusteeships. At the present time I am administering approximately seventy-five railroad issues in my division of the department. The trust company, either under its present name or its former name of The Farmers' Loan and Trust Company, has taken part in many railroad reorganizations. In the course of the work I personally have done in connection with the reorganization of corporations which have given mortgages to the trust company, I have been consulted frequently by the holders of the securities with respect to the merits of plans of reorganization or readjustment which have been from time to time proposed for the securities, in a great many cases.

* * * * * *

In the last ten years I have been working on the railroad reorganizations of the Chicago, Milwaukee, St. Paul & Pacific, the Chicago & North Western, the Erie, the New York, New Haven & Hartford, the Minneapolis & St. Louis, the Savannah and Atlanta, the Missouri Pacific, and I think that covers a fair part of the list.

* * * * * *

I am familiar with the exhibit which was introduced this morning as City Bank Farmers Trust Company Exhibit 10 [See R. 349] which is a table of income available for interest

and interest upon certain senior securities. I am also familiar with the table which was introduced as City Bank Farmers Trust Company Exhibit 11 [See R. 350] which refers to some eleven reorganization proposals which have been made in this case as well as the provision made for the claims of the General Mortgage Bonds in those proposals, and set alongside of them certain figures in regard to the current earnings of the debtor available for interest in the years in which the proposal was made, as well as the net situation up to the last previous December 31st prior to the date on which such proposal was made with respect to such earnings available for interest as contrasted with such senior interest requirements.

I have been from time to time, as the various figures were available, in a general way familiar with all the figures which are for convenience set forth in tabular form on those exhibits.

I have considered the relationship between the several treatments proposed for the General Mortgage Bondholders from time to time as contrasted with what appeared to be the current earning situation of the debtor at the time those proposals were made. I have been following the earnings monthly, Mr. Watts.

From my communications from bondholders, whether in the form of personal visitations, telephone conversations or letters, I am certain that at least some of the bondholders have considered the proposals made for the General Mortgage Bonds in the light of those figures.

"Q. In your opinion does the current earning situation of a railroad generally have any bearing upon the reasonableness of a proposal to the creditors of that railroad, particularly where it is a proposal that such creditors should accept in a plan for reorganization securities different from what they hold? A. Well, in my opinion the earnings have some bearing.

"Q. And does the result of operations to the last practicable date have a bearing upon the reasonableness of the proposal made? A. Yes, I think so.

"Q. Did you, Mr. Morton, or anyone else in the Corporate Trust Department of the City Bank Farmers Trust Company make any recommendation to any holder of General Mortgage Bonds as to how they should vote on this plan of reorganization? A. *The City Bank Farmers Trust Company as Trustee under this General Mortgage made no recommendation to any bondholder as to whether he should vote to affirm or reject the plan.*

"Q. Can you state briefly why you followed that policy? A. Well, we had been making recommendations before the Commission and Court over a period of years on behalf of bondholders. We had been approached I suppose a half dozen times by various groups of bondholders who were giving consideration to the formation of a protective committee for the bonds. We have offered them all encouragement in each case to go ahead with the formation of the committee. After the plan was approved by the Court we thought that it was only appropriate to let the bondholders decide on the basis of their individual circumstances as to whether or not they wished to accept or reject the plan.

"Q. So the vote of 79.33 per cent of the General Mortgage Bondholders who voted to reject the plan was not based in any way upon any recommendation by the Mortgage Trustee that they should vote against the plan? A. It was not."

. . . . . .

"Q. *Mr. Morton, on the basis of the facts which for convenience are arranged in tabular form on these two exhibits, and on the basis of all the information that was available to the bondholders from time to time, was it in your opinion reasonable or unreasonable for the bondholders to vote to reject the plan?* A. *Yes, reasonable.*

"Mr. Gibson: Your Honor please, an objection to the preceding question of the preceding witness was sustained.

"Mr. Watts: No, it was not sustained.

"Mr. Gibson: I object on the ground that the question is calling for an opinion on an issue for the Court to decide.

"The Court: Objection sustained."

3. Report of Federal Coordinator of Transportation on Transportation Legislation (part of H. Doc. No. 89, 74th Congress, 1st Session)*

January 21, 1935

To the Interstate Commerce Commission:

In accordance with the duty laid upon the Federal Coordinator of Transportation in section 13 of title I of the Emergency Railroad Transportation Act, 1933, the purpose of this report is to submit recommendations for further legislation to improve transportation conditions throughout the country, which the Commission shall transmit with its comments to the President and to the Congress (p. 1).

* * * * *

Bankruptcy Act Revision

* * * * *

Section 77 was designed with the purpose of expediting reorganizations, but there has been slow progress under it. No better progress has been made in the equity proceedings. The depression has been largely responsible for this slowness, but there are deficiencies in section 77 which should be cured by amendment, and particularly by amendments designed to minimize the difficulties in obtaining the assents of creditors and shareholders.

Among the important amendments proposed are these:

1. While it is undesirable to amend section 77 in a manner to force reorganizations where the times are not propitious for sound reorganizations, it is clear that the

* The full Report, of which this is an extract, was sent to the President, the President of the Senate, and the Speaker of the House of Representatives with a Letter of Transmittal, dated January 23, 1935, by Hugh M. Tate, as chairman of the Interstate Commerce Commission.

law should be so arranged as to require reorganizations as soon as conditions are right and to prevent obstructive action by minorities for purposes of selfish gain. The present act was a right step in this direction in providing that approval of a plan by two-thirds of any class of creditors or shareholders is binding upon the minority of such class. But a fair and equitable plan may be defeated if not approved by two-thirds. As the law is now drawn, it seems to be generally believed that the power lies in minorities to block any reorganization. While it is not thought desirable to dispense with the securing of consents from the creditors and shareholders, it is clear that there should be provisions whereby a court may, under some circumstances, make effective a fair and equitable plan over the dissent of minorities, under an arrangement insuring a full hearing to all of the parties concerned and an adjudication by the Commission and the court establishing the fairness of the plan. It is, therefore, proposed to liberalize the procedure so that the Commission, considering the plans of any who may propose them, shall tentatively approve a plan which shall be passed upon by the court after hearing the objections of any party of interest. The plan, if approved by the court, shall then be submitted to the interested creditors and shareholders. The consents of two-thirds of each class of creditors and stockholders shall bind the minorities in such classes. But, if the court shall find that the plan is fair and equitable, it may make it effective, even if not so approved.

Arbitrary compulsion of plans over the dissents of the interested classes is not intended, nor is it believed that the courts will override strong dissents by any large number of such classes, or by a single large class, excepting where it is established that they have no interest in the property. Rather, the purpose is to prevent the obstruction of plans which are favored by the larger classes of creditors or shareholders, but which are obstructed by minorities in the smaller classes in the attempt to secure unduly preferential treatment. From a legal standpoint

there are no apparent objections to this course. It puts emphasis upon the adjudication of these rights by providing for hearings before the Commission and the courts under prescribed principles of substantive law, whereby there must be, among other things, a proper recognition of the priorities of the respective interests (pp. 161-2).

* * * * *

The bill providing for the proposed revision of section 77 of the Bankruptcy Act is herewith submitted as Appendix X (p. 103). * * *

JOSEPH B. EASTMAN,
Federal Coordinator of Transportation

(p. 105)

4. Extract from Report No. 1283, dated June 21, 1935, House of Representatives, 74th Congress, 1st Session

HOUSE OF REPRESENTATIVES

74th Congress, 1st Session } Report No. 1283

REORGANIZATION OF RAILROADS UNDER THE BANKRUPTCY ACT

June 21, 1935.—Referred to the House Calendar and ordered to be printed

Mr. Sumners of Texas, from the Committee on the Judiciary, submitted the following

REPORT

[To accompany H. R. 8587]

The Committee on the Judiciary, to whom was referred the bill, H. R. 8587, to amend section 77 of the Bankruptcy Act, after consideration, report the same favorably to the House with the recommendation that the bill do pass.

The purpose of the bill is to provide amendments which have been demonstrated as necessary by experience in the administration of section 77 of the Bankruptcy Act, entitled "Reorganization of Railroads engaged in Interstate Commerce", which was enacted by the Seventy-second Congress, second session, (act of Mar. 3, 1933, 47 Stat. 1477; U. S. C., title 11, sec. 205). About 55 railroads with a mileage of something over 43,000 miles are now involved in bankruptcy or receivership proceedings. Hon. Joseph B. Eastman, the Federal Coordinator of Transportation, in a report to Congress (transmitted Jan. 23, 1935; 74th

Cong., 1st sess., H. Doc. No. 89)* recommended the revision of section 77 and submitted a bill incorporating his proposed amendments (pp. 35, 100, 229). That bill has been the basis of the work of your committee (p. 1).

* * * * *

One of the main difficulties with reference to the present act is that a minority of more than one-third of any one class of creditors can obstruct and prevent the approval of any plan. This bill provides that two-thirds of those of each class who vote upon the plan will bind the dissenters and those of the class who fail to record their votes as provided by the act. It also provides that the court may make effective a fair and equitable plan over the dissent of such minorities. Under its provisions, the Commission will tentatively approve the reorganization plan; it will then be passed upon by the court after hearing the objections of all parties in interest. Before approving it, the court must find that the plan is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders.

The plan, if approved by the court, will then be submitted to the creditors and shareholders. The consent of two-thirds of those of each class who vote upon the plan will bind the remainder in that class. But the judge may make the plan effective, even if not so accepted, if he finds that it conforms to the requirements just stated, provides fair and equitable treatment for the interests of those rejecting it, and that their rejection is not reasonably justified in the light of their respective rights and interests (pp. 2-3).

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* Extract from H. Doc. No. 89 appears in this appendix at pages 1-3.

In order to protect the rights of stockholders and creditors which might be injured by a reorganization on the basis of depressed conditions in the event of an early return to prosperous times, paragraph (b) clause (3) provides that the plan may require the issuance of securities in the form of options or warrants to receive, or to subscribe for, the securities of the reorganized company to security holders who otherwise are not provided for in the plan (p. 3).

5. Extract from Report No. 1336, dated July 29, 1935, Senate, 74th Congress, 1st Session

SENATE

CALENDAR No. 1388

74th Congress, 1st Session } Report No. 1336

REORGANIZATION OF RAILROADS UNDER THE BANKRUPTCY ACT

July 29 (calendar day, August 16), 1935—Order to be printed

MR. WHEELER, from the Committee on Interstate Commerce, submitted the following

REPORT

[To accompany S. 1634]

The Committee on Interstate Commerce, to whom was referred the bill (S. 1634) to amend section 77 of the Bankruptcy Act, having considered the same and adopted certain amendments, report the bill back favorably to the Senate with the recommendation that it be passed. A similar bill was introduced in the House of Representatives and was reported favorably by the Committee on the Judiciary of the House with certain amendments (H. R. 8587; Rept. 1283, June 21, 1935). The bill, S. 1634, as amended, which your committee hereby recommends, is the same as the bill, H. R. 8587, as reported by the Committee on the Judiciary of the House in the said report. H. R. 8587 as thus reported was passed by the House of Representatives, with certain amendments made on the floor, on August 15, 1935. * * * (p. 1).

The purpose of the bill is to provide amendments which have been demonstrated as necessary by experience in the administration of section 77 of the Bankruptcy Act, entitled "Reorganization of Railroads Engaged in Interstate Commerce", which was enacted by the Seventy-second Congress, second session (act of Mar. 3, 1933, 47 Stat. 1477, U. S. C., title 11, sec. 205). It is necessary that this bill be passed now because 85 railroads, with a mileage of something over 58,815 miles, are now involved in bankruptcy or receivership proceedings and, for reasons to be here stated, amendments of the law are essential to enable the efficient reorganization of these properties (p. 1).

* * * * *

Hon. Joseph B. Eastman, the Federal Coordinator of Transportation, in a report to Congress (transmitted Jan. 23, 1935; 74th Cong., 1st sess., H. Doc. No. 89)* recommended the revision of section 77 and submitted a bill incorporating his proposed amendments (pp. 35, 100, 229). That bill has been the basis of S. 1634 and H. R. 8587.

* * *

The important amendments to section 77 incorporated in S. 1634, as amended, are as follows:

(1) While section 77 is in general an admirable piece of legislation, in certain respects it has been found unworkable. The act was designed to prevent the obstruction of reorganizations by minorities by providing that the approval of a reorganization plan by two-thirds of any class of creditors or security holders is binding upon the minority in a class. But, if not so approved, a fair and equitable plan may be defeated. Not only may one-third of the security holders of any class prevent a fair plan from binding that class and thus require that their securities be bargained for, but the mere failure to vote upon a plan by those holding one-third of the securities of a single class

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* Extract from H. Doc. No. 89 appears in this appendix at pages 1-3.

will effectively block any reorganization. The formidability of such obstructive possibilities appears clearly in the pending reorganization of the Missouri Pacific, where the claim is made that there are 72 different classes of security holders. One bank loan from J. P. Morgan & Co. is put in a separate class. Each of such classes of creditors, if it does not agree to a plan, can drive a bargain with those endeavoring to reorganize the company, and is in a superior bargaining position. Further, the consent of two-thirds of each class of stockholders must be acquired, unless, by an elaborate valuation proceeding, it is proved that the value of the property is so low that the stock has no interest. This is an effective obstruction. Such valuation proceedings, if the appraisal method is followed, are of a volume almost unparelleled in any other sort of litigation. In a pending reorganization, the Commission has postponed such action in the hope that the act will be amended.

In order to remedy these defects, S. 1634, as amended, provides that two-thirds of those of each class who vote upon a plan will bind the dissenters or those failing to vote. But it also provides that the court may make effective a fair plan where the parties do not agree. If the Commission tentatively approves a reorganization plan, it is submitted to the court for approval. The court must find that the plan is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders. These standards require that the plan be prepared with scrupulous regard for the rights of all the parties. The plan, if thus approved by the court, will then be submitted to the creditors and shareholders. If two-thirds of each class consent, the plan will bind the remainder of each class. But the judge may make the plan effective, even if not so accepted, if he finds that it conforms to the requirements just stated, provides fair and equitable treatment for the interests of those re-

jecting it, and that their rejection is not reasonably justified in the light of the respective rights and interests. These provisions give complete due process of law from a procedural standpoint, there being provision for full hearings both before the commission and the court. Within the broad powers of Congress under the bankruptcy clause as recently declared by the Supreme Court in *Continental Illinois Bank & Trust Co. v. Chicago, Rock Island & Pacific Ry. Co.* (55 Sup. Ct. Rep. 595), the provisions also afford due process of law in fully protecting the property rights which are involved (pp. 2-3).

(2) S. 1634, as amended, is designed to protect the stockholders and creditors against unnecessary sacrifice in reorganizations made in a period of depression, when conditions are transient. In order to protect the rights of stockholders and creditors who might be injured by a reorganization on the basis of depressed conditions in the event of an early return to prosperous times, paragraph (b) clause (3) requires that the plan may allow the issuance of securities in the form of options or warrants to receive, or subscribe for, the securities of the reorganized company, to security holders who are not otherwise provided for in the plan (pp. 3-4):

6. Extract from Congressional Record, Vol, 79, Part 12, pages 13298-301, containing statements and debate in the House of Representatives, 74th Congress, 1st Session, on August 15, 1935 in connection with the proposed amendment of the Bankruptcy Act (H. R. 8587).

Mr. SUMNERS* of Texas. Mr. Chairman, this bill has to do with railroad reorganization * * * (p. 13298).

The Congress adopted legislation known as "section 77" of the Bankruptcy Act. The general plan of this legislation was to have the persons in interest agree upon a plan of reorganization. I shall not go into the details, but one difficulty that has been encountered, which, according to persons in best positions to know, makes it impossible to reorganize, is that the persons in interest group themselves into a great many classes. I believe in the Missouri Pacific case there were probably 72 classes. Under the law as it is now, reorganization cannot be effected unless the consent of two-thirds of each class is obtained.

This legislation, of course, we all know is largely experimental. I would not undertake, on my responsibility, to tell you I feel certain that the bill that is offered will work. We do not know. However, those in the best position to know feel hopeful that the bill that is offered will work. It seeks to get around the difficulty of permitting one class to block a plan. We pursue a method very similar to the present method of getting a plan presented. * * * (pp. 13298-9).

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To preserve rights of stockholders and creditors, not otherwise provided for, which might be injured by reorganization under depressed conditions, a "rain check" provision for the issuance of options or warrants to receive securities in the reorganized company in the event of early

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* Mr. Summers was in charge of the bill in the House of Representatives.

return to prosperous conditions may be included in the plan.

Two-thirds of the creditors of each class who vote will bind the class instead of the two-thirds of the entire class required by present law.

In the event the consent of two-thirds of those who vote is not obtained, the judge may nevertheless effectuate the plan if he finds that the objections are not reasonably justified in the light of the respective interests of the objectors (p. 13299).

* * * *

Mr. McFARLANE. What changes in the present law does this bill make, briefly stated?

Mr. SUMNERS of Texas. The most important change is that whereas under the present law there is required the consent of two-thirds of each class, it is made possible for the Commission and the court, after consideration of the plan—and they may modify the plan—if it is a fair and just plan and meets the constitutional requirements, it is possible to have a plan effectuated which has not been approved by two-thirds of each class (p. 13299).

* * * *

Mr. BIERMANN. It now takes two-thirds, and under your plan it states no definite number?

Mr. SUMNERS of Texas. That is right; and we feel that we have fully protected the constitutionality of the bill by providing that the plan must meet with—I have not the exact language of the bill in my mind—but it must comply with the law of the land (p. 13299).

* * * *

Mr. MICHENER. * * * In passing upon this bill we are not embarking upon a new policy. When the Congress passed section 77 of the bankruptcy law this method of railroad reorganization was given legislative sanction. The

purpose of this legislation is to accelerate railroad reorganization as contemplated when section 77 was enacted.

Before the enactment of said section 77 the only method by which a railroad might be reorganized was through the equity courts. The costs were unconscionable. The delays were interminable. And, 9 times out of 10 an agreement between the executives and the primary security holders resulted in the wiping out of the small equity holders. * * * (p. 13300).

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The genesis of this bill was in the office of the Coordinator of Railroads. Mr. Craven, counsel to the Coordinator, presented a bill to our committee. It has been rewritten many times. Mr. Craven has given splendid assistance. He cooperated at all times and never dictated. He apparently had no pride of authorship but his was a spirit of helpfulness. Many crude committee amendments have been worked out by Mr. Craven, and I am sure that I speak the sentiment of the entire committee when I utter this word of appreciation (p. 13300).

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Personally, I do not believe that this is the opportune time to force unreasonable reorganization of the railroads. Due consideration must be given under these amendments to the equities and priorities of those interested. And that which is an innovation provides them with what we in the committee came to call the "rain check" provision of the bill. This provision will be explained by the gentleman from Nebraska [Mr. McLaughlin]. It guarantees to the last equity holder every possible chance to realize on his investment if business does pick up and the railroads again become profitable (p. 13300).

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Mr. McLaughlin. Mr. Chairman, the bill under consideration has had the attention of the Committee on the

judiciary and of a special subcommittee of that committee since this Congress began its present session, as has been outlined by my colleague from Michigan [Mr. MICHENER]. In the drafting of this bill the committee has had the able assistance of Mr. Craven, attorney for the Coordinator of Transportation, Mr. Eastman, but he has not dictated this bill in any sense, and has been entirely cooperative in the matter of amendments or changes to the bill as it was originally suggested by him (p. 13301).

I call your attention to the outstanding features of this bill with relation to the features of the present law which need correction. The present act provides that two-thirds of those voting, whether they be creditors or stockholders, can bind all of a class, instead of two-thirds of the entire class, as in the present law. In other words, under the present law, a minority of one-third may block a reorganization. That is corrected by the bill H. R. 8587 which is now before us.

Second, the act provides that the court may make the plan operative over dissenting creditors, if he finds that their rejection is not justified in the light of their interest. This provision facilitates reorganizations in those cases where no reasonable objection is presented (p. 13301).

One of the important features of this bill is what is known in the parlance of the committee, as the "rain-check feature", which provides that stockholders may receive evidences of their interest of participation in the corporation, so that if the rehabilitation of the railroad reaches a point where the stock again has a value, the stockholders automatically participate as they did under the old corporation (p. 13301).

7. Extract from Congressional Record, Vol. 79, Part 13, pages 13764-8 containing statements and debate in the Senate, 74th Congress, 1st Session, on August 20, 1935 in connection with the proposed amendment of the Bankruptcy Act (H. R. 8587).

Mr. WHEELER.* Mr. President, I wish to make a brief explanation of the bill and the reason for the amendment of section 77 of the bankruptcy act (p. 13764).

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D. H. R. 8587 is the result of a general overhauling of the act and includes the following important amendments:

First. The most important changes are provisions permitting making present plans effective. Under the present law, if more than one-third dissent or fail to vote, a plan, which is fair and equitable is blocked—the act requiring that two-thirds of each class must approve the plan. There are said to be 72 classes of creditors and stockholders in the Missouri Pacific case and 35 of 40 classes in the Rock Island case. In the instance of the Missouri Pacific, J. P. Morgan Co. has a bank loan of $6,000,000—I am merely citing this case as an illustration—classified in a single class, and has in hock the controlling stock interests of the Van Sweringens. This means that it is impossible to get through a plan without either meeting the Morgan's terms or paying the value of their interest in cash.

In other words, it makes it possible for a man who holds something over one-third of some one small class of debt absolutely to say that no reorganization plan can take place no matter how fair it may be, "Unless you either buy me out or pay me the full amount of my debt to the detriment of the other classes" (p. 13764).

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* Mr. Wheeler was in charge of the bill in the Senate.

Mr. Wheeler. * * * It is not possible under the present law to overcome the obstruction of the equity holders without a valuation which will establish that they have no equity in the property. The valuation hearings are almost without any equal in jurisprudence for size and expense. Consequently, in the pending Frisco reorganization, the Commission has found it necessary to postpone any further action until the act is amended; otherwise they would have to go through a complete valuation of the Frisco system, and it would take years for them to complete that valuation in order to get a reorganization as the set-up is at present.

These difficulties are overcome by the amendments which are proposed as follows:

The bill provides that if two-thirds of each class approve the plan it will bind the minorities.

It also provides that the court may make effective a plan where two-thirds do not agree, provided the court finds that the plan is fair and equitable, affords due recognition of the rights of each class of creditors and stockholders, will conform to the requirements of the law of the land, and that the rejection of the plan is not justified in the light of the respective rights of those rejecting.

Mr. Hastings. Mr. President, will the Senator yield?

Mr. Wheeler. I yield.

Mr. Hastings. The old bill provided that two-thirds of any class should be controlling, but this bill provides that two-thirds of those voting shall control; is that not correct?

Mr. Wheeler. Yes; that is, of each class.

Mr. Hastings. That is correct.

Mr. Wheeler. In the Van Sweringen case there are said to be 72 different classes.

Mr. Hastings. Mr. President, I am not complaining about it, but I desired to point out to the Senator, as the Senator went along, that there has been a change now, so instead of being two-thirds of the class, it is two-thirds of the voting in the class.

Mr. Wheeler. That is correct (p. 13764).

* * * *

Third. It is intended to protect the stockholders and creditors against injustice due to reorganizations based on depressed conditions which may be transient. Paragraph (b), clause 3, page 6, line 11, authorizes the issuance of options or warrants to receive, or subscribe for, securities—these being so-called "rain check" securities.

In a recent reorganization of an industrial concern many of the stockholders were completely wiped out. They were given no new stock. They received nothing at all.

Then after reorganization business began to pick up because of more prosperous conditions, but these stockholders who had invested their money remained completely wiped out, while other investors reaped the reward. This so-called "rain check" device is to protect that class of stockholders (p. 13765).

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Mr. WHEELER. * * *

Coming now to the question of due process:

Before the reorganization can take place the court must make the following findings:

> That the plan is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders. These standards require that the plan be prepared with scrupulous regard for the rights of all the parties. The plan, if thus approved by the court, will then be submitted to the creditors and shareholders. If two-thirds of each class consent, the plan will bind the remainder of each class. But the judge may make the plan effective, even if not so accepted, if he finds that it conforms to the requirements just stated, provides fair and equitable treatment for the interests of those rejecting it, and that their rejection is not reasonably justified in the light of the respective rights and interests. These provisions give complete due

process of law from a procedural standpoint, there being provision for full hearings both before the commission and the court. Within the broad powers of Congress under the bankruptcy clause as recently declared by the Supreme Court in *Continental Illinois Bank & Trust Co.* v. *Chicago, Rock Island & Pacific Ry. Co.* (55 Sup. Ct. Rept. 595), the provisions also afford due process of law in fully protecting the property rights which are involved (pp. 13765-6).

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Mr. HASTINGS. * * *

With respect to the particular section, my understanding is that Mr. Craven, counsel for the Coordinator, who has been working diligently for at least a year upon the subject, found, as the railroads have found, many difficulties. For instance, I doubt whether anyone knew little or nothing about it would suspect that there could be 72 classes of creditors of any great railroad corporation in the country. It is realized, of course, how difficult it is to get 66⅔ percent of the creditors of 72 classes to agree.

Originally the question was—and, of course, it was to be decided by the Congress itself—whether or not one-third of the creditors should be compelled to agree with the opinion of two-thirds. Anyone who has had anything to do with the matter of reorganizing a corporation has had the experience of having some man or some few people standing out, demanding 100 percent payment of their claims, and thereby preventing reorganization of the corporation. It was sought to get away from that difficulty.

I do not recall that the Senator from Montana [Mr. Wheeler] emphasized this point, but I wish to emphasize it and express my own opinion with respect to the change proposed to be made in the law. The original law provided that 66⅔ percent of all classes must agree to the plan of reorganization; and if they should not agree, the court would have the right to ascertain the value of their claims and to pay them in cash. The bill changes that in two particulars, and this is of great importance.

In the first place, the bill provides that 66⅔ percent of those voting shall decide the question. That, I believe, is not unreasonable. It must be realized that in railroad corporations, with the securities scattered all over the country, it is frequently very difficult, even if the security holders agree, to get in touch with them and to get 66⅔ percent of a particular class. I think it is not unreasonable to provide that 66⅔ percent of the class which is represented shall vote and shall determine whether that class shall agree with the plan or whether it shall not.

There is a matter in the bill which is of greater importance. Even if no vote at all is obtained from a certain class, even if the whole class objects, it is provided that the court, if it finds the plan to be equitable and fair for that particular class, may force that class to agree even though all in that class object. The court, of course, will go a long way before agreeing to that if there be a real controversy. Of course, if the court should find some particular class refusing to participate simply for the purpose of holding up the reorganization, it could deal with the situation under the amendment proposed in the bill (p. 13766).

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Mr. KING. Suppose the 1 class out of the 20 or 30 or even 70 held a preponderating interest in the corporation, either in the stock or the bonds or as a creditor, and the corporation or the person holding the preponderating interest objected, could it or he be forced to accept the terms?

Mr. HASTINGS. They could be under this plan, always with the approval of the court and with the right of appeal if the court dealt unfairly with them (p. 13766).

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Mr. WHEELER. Not only must it be approved by the court, but it must be approved also by the Interstate Commerce Commission.

Mr. HASTINGS. Yes; I had overlooked that fact.

Mr. WHEELER. There is a double check upon the situation under that provision.

Mr. HASTINGS. Yes; there is a right of appeal to the circuit court from the decision of either of them.

Mr. WHEELER. Yes. As the Senator from Delaware pointed out, if we have as many as 72 classe of creditors, one class may come in and say to all the rest, "Unless you pay us out in cash we will hold up any reorganization." Everybody appreciates that the bill which the Senator from Delaware introduced originally was a step in the right direction. As he said, it was passed hurriedly toward the end of the session for the purpose of permitting reorganization, but it was found it did not work out practically.

Mr. HASTINGS. I may say to the Senator from Utah [Mr. King] that Congress is undoubtedly giving to the courts and to the Interstate Commerce Commission very great power. There is no doubt about that. However, so far as I am concerned, I have always been willing to leave such questions as are here involved to the Federal courts of the land, which, I think, constitute the finest branch of our Government, with the right of appeal. Occasionally the courts will make a mistake and occasionally an injustice will be done, but some place we have to leave that authority.

In this particular instance there is a double check. It is necessary to have the approval of the Interstate Commerce Commision and the approval of the district judge before whom the matter is being tried, and then there is always the right of appeal to the circuit court. Although we are giving this very great authority, I am quite satisfied that it has become necessary in order to make the bill workable that we should give that unusual authority (pp. 13766-7).

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Mr. KING. Suppose a majority of the bondholders—and I suppose there would be a mortgage or trust deed to secure the payment of the bonds—should determine to go

into court and foreclose for the purpose of obtaining judgment relief for the creditors. Under the bill they would be denied that opportunity, would they not (p. 13767)?

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Mr. WHEELER. The bill provides just the same as the ordinary statute for composition of the debts of the railroad company (p. 13767).

* * * *

Mr. KING.

The Bankruptcy Act, of which the measure before us is supplemental, was designed to aid the crippled railroads and to bring about, if possible, reorganizations so that they might render improved service to the public and prevent the stockholders and the owners and holders of securities from sustaining irreparable losses (p. 13768).